BUY AMERICAN RESTRICTION IN FISCAL YEAR 1983 SUPPLEMENTAL APPROPRIATION ON PROCUREMENT OF CERTAIN AIRCRAFT

HEARING

BEFORE THE

SUBCOMMITTEE ON TRADE

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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BUY AMERICAN RESTRICTION IN FISCAL YEAR 1983 SUPPLEMENTAL APPROPRIATION ON PROCUREMENT OF CERTAIN AIRCRAFT

MONDAY, JUNE 13, 1983

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON TRADE,
Washington, D.C.

The subcommittee met at 2 p.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press release of Friday, June 3, 1983]

HON. SAM M. GIBBONS, CHAIRMAN, SUBCOMMITTEE ON TRADE, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARING REGARDING BUY AMERICAN RESTRICTION IN FISCAL YEAR 1983 SUPPLEMENTAL APPROPRIATION ON PROCUREMENT OF CERTAIN AIRCRAFT

The Honorable Sam M. Gibbons (D.-Fla.), Chairman of the Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Subcommittee will hold an oversight hearing on Monday, June 13, 1983, on the policy position of the Department of Defense and its basis with respect to the Buy American restriction on procurement of replacement aircraft for the CT-39 aircraft contained in Title I, Chapter III, of H.R. 3069, Supplemental Appropriation for Fiscal Year 1983, passed by the House of Representatives on May 25, 1983. The provision is as follows:

"Funds available to the Department of Defense during the current fiscal year may not be obligated to acquire (by lease or purchase) a replacement aircraft for the CT-39 aircraft from other than a United States firm and such replacement aircraft must be assembled in the United States and utiltize an airframe manufactured in the United States."

Officials from the Department of Defense will be the sole witnesses.

The hearing will begin at 2:00 p.m. in the main Committee hearing room, 1100 Longworth House Office Building.

Chairman GIBBONS. Good afternoon, ladies and gentlemen.

This is an oversight hearing of the Subcommittee on Trade in which we are looking into a Buy American restriction in the supplemental appropriations bill for fiscal year 1983.

H.R. 3069 prohibits the use of funds by the Department of Defense to acquire CT-39 replacement aircraft from other than a U.S. firm.

Such aircraft must also be assembled in the United States and must utilize a U.S. airframe. The components, engines, and other parts may be supplied from foreign or U.S. sources.

The purpose of this hearing is to determine the policy position of the Department of Defense with respect to the legislative provision and its impact upon trade.

I am very concerned about the increasing number of Buy American provisions included in appropriations bills restricting procurement by the Department of Defense and other agencies from foreign services.

Our existing Buy American laws already provide U.S. industries with a greater rate of protection over imports in Government purchasing than in the commercial marketplace.

Such restrictions on defense purchases anger our allies and can result in reduced military purchases from U.S. exporters to the detriment of our present large trade surplus in military sales. The trade impact and significant trade policy implications of such legislation need to be more carefully considered.

Our principal witnesses today are from the Department of the Air Force to discuss their policy with respect to the CT-39 replacement aircraft. We thank you for appearing today.

Let's see. Our first witness is the Honorable Willard H. Mitchell, Principal Deputy Assistant Secretary of the Air Force for Financial Management.

STATEMENT OF WILLARD H. MITCHELL, PRINCIPAL DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE FOR FINANCIAL MANAGEMENT, ACCOMPANIED BY BRIG. GEN. BERNARD L. WEISS, DIRECTOR OF CONTRACTING AND MANUFACTURING POLICY, DEPUTY CHIEF OF STAFF FOR RESEARCH, DEVELOPMENT AND ACQUISITION, HEADQUARTERS USAF, AND COL. RONALD L. CARLBERG, USAF, DIRECTOR OF INTERNATIONAL ACQUISITION, DEPARTMENT OF DEFENSE

Mr. MITCHELL. Thank you, Mr. Chairman. I would like to introduce Brig. Gen. Bernard L. Weiss, who is Director of Contracting and Manufacturing Policy, Headquarters, U.S. Air Force.

Chairman GIBBONS. General Weiss, we are glad to have you here.

General WEISS. Thank you.

Mr. MITCHELL. General Weiss has a prepared statement we would like to read for the record, sir, with your permission.

Chairman GIBBONS. Either of you may proceed as you wish.

General WEISS. Thank you. I would like to also introduce Colonel Carlberg, Director of International Acquisition within the Undersecretary of Defense Office for Research.

Chairman GIBBONS. Colonel Carlberg, we are glad to have you.

Colonel CARLBERG. Thank you, sir.

General WEISS. Mr. Chairman, I am very pleased and proud to be here today on behalf of the Secretary of the Air Force and thank you for the opportunity to share with you and meet with you to discuss the CT-39 replacement program with particular attention to and emphasis on foreign competition.

I am the Director of Contracting and Manufacturing Policy at Headquarters, U.S. Air Force.

I am also the primary focal point for Air Force acquisition policy. Accordingly, on behalf of the Secretary I have been specifically di-

rected to speak for him with you here today in our discussion of Air Force policy regarding the CT-39 replacement program.

As you are aware, the CT-39 replacement program is an effort to replace our fuel-inefficient and aged fleet of CT-39 aircraft with a lease of new, commercial, off-the-shelf business aircraft.

This program was initiated late last year and is currently in source selection with contract award anticipated within the next 90 days. Because the program is in the source selection phase, I am unable to provide the specifics regarding the proposals received.

Such information is classified as source selection sensitive. However, I believe discussing the acquisition strategy may answer many of your questions.

The CT-39 replacement program has been a competitive program from the start. We solicited U.S. domestic firms, as well as foreign.

This competitive program is in compliance with the defense acquisition regulation, I refer to it as the DAR, and Federal statutes. This is also consistent with the various reciprocal procurement agreements we have with our NATO allies.

Since there has been some discussion on why foreign firms were competing for this requirement, I wish to note that we had no legal basis to exclude foreign firms from competing in this program.

To the contrary, such a restriction would violate the principles of the NATO MOU's whose basic purpose is to open up competition within the alliance and achieve more effective expenditures of our collective defense budgets.

However, we understood there was an intention to introduce legislation restricting competition in this program to U.S. firms only. Accordingly, as a precaution, we included a statement in the CT-39 replacement solicitation putting competitors on notice in advance that if such a provision were enacted, foreign competitors would be excluded.

When no provision to restrict foreign participation was enacted, we had no legal basis other than to consider all qualified offerors, both domestic and foreign.

While foreign competitors may compete in most of our acquisitions, they are generally subject to the application of the Buy American Act. The act establishes a preference for U.S. products by adding a price differential to the foreign product for evaluation purposes.

The act provides, however, an exemption to these restrictions in specific instances.

Pursuant to the sense of Congress as reflected in the Culver-Nunn amendment to the 1977 Defense Authorization Act, the Defense Department exempted the application of the Buy American Act for the NATO reciprocal purchasing agreements.

The Department of Defense entered into these reciprocal agreements to enhance defense readiness by fostering standardization and interoperability of defense equipment. These agreements are reciprocal and remove the various buy national restrictions of participating countries.

Mr. Chairman, this concludes my prepared statement. I and my colleagues will be very happy to answer any questions you may have, sir.

Chairman GIBBONS. Does the Department of Defense support the language on page 9 of H.R. 3069?

General WEISS. The Department of Defense does not support the language of the reference that you made, sir. We believe in maximizing competition, and have fostered that, or attempted to foster that under the restrictions that have been imposed upon us.

Chairman GIBBONS. So if you had had your way, this language would not have been in the bill; is that right?

General WEISS. Yes, sir. We would prefer to be able to abide by our reciprocal agreements with our NATO allies. We would also like to maximize the opportunity for competition.

Chairman GIBBONS. Have you got any idea how this appeared in the bill? I can't find any father for this language.

I wouldn't classify it as a fatherless child, but it certainly is wondering who its father is.

Mr. MITCHELL. The language was introduced, sir, by the House Appropriations Committee during their consideration of the 1983 supplemental, and was subsequently adopted in the version of that bill which went to the House floor.

A similar provision is currently—is in the current version of the Senate bill, which is being debated at this time on the Senate side.

Chairman GIBBONS. How do these things get in these bills, if you all don't support them? I thought you had a lot of influence around here.

I have always had a great deal of respect for you personally.

Mr. MITCHELL. A great many things find their way into legislation, sir, that the Department does not support.

Chairman GIBBONS. Did you all take any kind of vigorous step to tell the committee that you didn't support this; that it might cost the United States more money, might embarrass us with some of our allies, some of our friends?

Mr. MITCHELL. Mr. Chairman, I think we have made our views known to the committee about not supporting this legislation. The committee feels that the cost of the program could be higher if certain kinds of foreign competition were allowed.

The Appropriations Committee appears to feel that because some foreign manufacturers are affiliated with their governments or otherwise enjoy direct subsidies from their governments, that they have an advantage in this kind of competition.

Chairman GIBBONS. We have laws that protect our domestic manufacturers from that, countervailing duty laws. If you have knowledge of that, you can ask that a bid be thrown out because we could countervail, or anybody could countervail against that.

We have got a Buy American provision. We have got countervailing duty laws. I just have no idea how this little provision gets in the bill on the House side and Senate side, and nobody claims parentage for it.

General WEISS. Mr. Chairman, the Secretary of the Air Force on the 11th of February of this year replied to the House Appropriations Committee, indicating it was the Air Force's intent to solicit all sources, both United States and foreign.

That was the position that the Air Force took with regard to any proposed legislation, and it still is the Air Force's position that we be able to obtain competition to the maximum extent possible, and

in line with our agreements with some of the foreign nations involved.

Chairman GIBBONS. Well, I know that in calendar year 1982, just with the NATO countries, we had a surplus in military sales of almost $3 billion. Are we purchasing this plane from any of the NATO countries, or leasing it?

Mr. MITCHELL. Source selection is currently in process, sir. Until the source selection is completed later this summer, we wouldn't know who the winning vendor is, whether or not the procurement will be from an American manufacturer or a non-American manufacturer.

Chairman GIBBONS. I think one of you just told me that you were worried about one of these countries subsidizing.

Mr. MITCHELL. Mr. Chairman, I was simply trying to relay to you the views that are expressed in the report of the House Appropriations Committee accompanying the fiscal year 1983 supplemental.

Chairman GIBBONS. Yes.

Mr. MITCHELL. Those are not the views of the Department of the Air Force or the Department of Defense.

Chairman GIBBONS. All right. Have we heard anything from our NATO allies about this little Buy American provision that excludes them?

Mr. MITCHELL. We have heard vocally from them on a continuing basis about their concern about the lack of American procurement in their countries. But I am not aware of any specific expressions of concern about this particular piece of legislation.

Chairman GIBBONS. Every time I run into them, they jump on me. They point out the tremendous surplus we have in military sales to them, and how we refuse to buy anything except some very insignificant things from them.

I know when I see them again, they are going to be asking me this same question. They perhaps are not totally aware this provision is in the bill.

Mr. MITCHELL. Mr. Chairman, we have another procurement going on for a small aircraft to augment our logistics operation in Europe—the European distribution system aircraft [EDSA]—which is being completed in the next fiscal year.

Because of the way the requirement for that aircraft has developed, there is a very strong probability that European manufacturers will have the best advantage in that source selection, and that that source selection will go to a European manufacturer, which is, I think, by way of saying that we have as a matter of departmental policy, not only no preference for a Buy American approach, where it is appropriate, we are perfectly prepared and very pleased to place procurements with our NATO allies.

Chairman GIBBONS. I didn't call this hearing for this purpose, but I can't pass over the subject. You are going to lease this plane?

Mr. MITCHELL. Yes, sir.

Chairman GIBBONS. How long have you been leasing planes like this?

Mr. MITCHELL. This will be the first—I am sorry. This will be the second aircraft that we have entered into a lease arrangement to acquire. We signed a contract last week for lease of three somewhat larger jet transport aircraft.

That was the first lease arrangement. This one is structured in a somewhat different way.

This will be a lease for 5 years, with a 3-year option to renew, with an option for the Government to purchase the aircraft at the end of the 5-year or the 8-year period.

We will make a determination at that time whether that is the most cost effective action to take at the time.

Chairman GIBBONS. How many of these do we plan to lease?

Mr. MITCHELL. The procurement calls for——

General WEISS. 120.

Mr. MITCHELL. 120 aircraft. But the buy is to be split between a turbojet and a turboprop, 40 of the turboprop version, and 80 of the turbo jet version.

We expect the deliveries will begin, depending on who wins the contract, probably early next year, and continue over probably about an 18- to 20-month period.

One of the advantages of the lease arrangement is that we are able to bring these aircraft into the inventory to replace the CT-39, which is now in excess of 20 years old, in a much quicker way.

In addition, the cost analysis that we have done and which we have reviewed extensively with OMB and the Treasury confirms that, even considering tax factors, this is more cost effective to the Government than a procurement, than a regular procurement in which we would buy the aircraft.

Chairman GIBBONS. I know this is a silly question, but do you plan to lease the MX missile, too?

Mr. MITCHELL. No, sir.

General WEISS. This is a very special case, Mr. Chairman. In this particular case, and it doesn't reflect a major policy or a policy shift on the part of the Air Force to lease equipment. This is a case where the operation and maintenance costs for the current CT-39 will more than take care of what we expect the lease cost to be.

So that there is no need to come up with any additional funds other than what it cost to operate the CT-39 up to this point. We view it as a very, very special case.

We do not see future application on a very broad or comprehensive basis to lease aircraft.

Mr. MITCHELL. One of the reasons that this kind of lease can be structured to be cost effective is that the type of aircraft that we are going to acquire are commercially available, off-the-shelf aircraft that have a residual market value.

For that reason, they can be resold by lessors at the end of the lease period to other buyers in the event the Government chooses not to procure them.

Because the price of these aircraft has held up well over the years, those residuals will probably be relatively attractive, meaning that the lessors can afford to take a little risk in the way they structure lease payments and offer a very attractive lease rate to the Government.

We would never consider leasing aircraft, missiles or any other kind of equipment that has a combat or combat-related function. From the viewpoint of the private sector, those aircraft have no residual value at all as there is no potential customer for them.

Chairman GIBBONS. As I sum up your testimony, you don't claim parentage for the language in the supplemental appropriations bill, and you are opposed to it; is that correct?

Mr. MITCHELL. That is correct, sir.

Chairman GIBBONS. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

I don't have any questions on the appropriations bill language.

I am intrigued by this leasing arrangement you are planning to go into. Have you gotten the written approval of the House Armed Services Committee?

Mr. MITCHELL. Yes, sir. This approach was reviewed by both the House and Senate Armed Services Committees and has been approved by our Appropriations Committees.

Mr. PEASE. By letter or bill, or what?

Mr. MITCHELL. No. This approach to the acquisition was endorsed in the continuing resolution that provided appropriations for the fiscal year 1983 bill.

Mr. PEASE. Could you furnish the subcommittee with the language from the fiscal year 1983 appropriations bill?

Mr. MITCHELL. Yes, sir. We would be happy to furnish that for the record.

[The information follows:]

The following are excerpts from the committee and conference reports as well as the public law:

Public Law 97-377, December 21, 1982:

"For expenses, not otherwise provided for, necessary for the operation and maintenance of the Air Force, as authorized by law, including the lease and associated maintenance of replacement aircraft for the CT-39 aircraft to the same extent and manner as authorized for service contracts by section 2306(g), title 10, United States Code; and not to exceed $4,490,000 can be used for emergencies and extraordinary expenses, to be expended on the approval or authority of the Secretary of the Air Force, and payments may be made on his certificate of necessity for confidential military purposes; $16,915,766,000, of which not less than $1,100,000,000 shall be available only for the maintenance of real property facilities."

Conference report:

TITLE VII—GENERAL PROVISIONS

Leasing of aircraft and vehicles to non-Federal agencies.—The conferees agree to Senate language with an amendment permitting such leasing when specifically authorized.

House appropriations Committee Report:

"The Air Force is presently developing plans for replacement of the CT-39 aircraft with a 6 to 8 passenger corporate type aircraft. The Committee supports this initiative since it should, over the life cycle of the replacement aircraft, be cost effective.

"The Committee, therefore, anticipates that the total aircraft fleet chosen will be capable of carrying out the mission with the greatest passenger and cargo load at the lowest cost and fuel consumption within the designated long or short haul categories. Further, it is anticipated that an appropriate mix of turboprop to fanjet aircraft will reflect the actual ratio of short haul to long haul flights experienced by Air Force operational support aircraft.

"To permit the Air Force to pursue the option of replacement by leasing, the Committee has included the necessary bill language under Operation and Maintenance, Air Force."

Senate Appropriations Committee Report:

"The Committee is informed the Air Force is considering a competitive charter of suitable aircraft to replace the aging CT-39 transport. The existing fleet of these business-type jet aircraft are nearing the end of their economically useful life. The Committee encourages the Air Force to pursue this initiative and, upon analysis, should a charter program offer cost advantages over procurement, the Air Force

may elect such an alternative within existing contractual authority. The Air Force is requested to keep the Committee apprised of developments and consult the Committee on any alternatives."

Mr. PEASE. You say that you worked up an extensive cost analysis study of this proposal; is that right?

Mr. MITCHELL. Yes. That is correct, yes. We have done an analysis which examines the cost trade-offs for buying and various forms of leasing and also for continuing to operate the current fleet of aircraft on into the future. We have done that running excursions to consider the tax cost, the loss of revenue that the Treasury would incur, because lessors would be eligible for the rapid writeoff and depreciation under the accelerated cost recovery system in the Tax Act of 1981.

We factored those costs to the Government back into the analysis, and this analysis shows that it will be more cost effective, even considering those tax factors, for us to lease this type of aircraft than to buy it outright. There are some unusual business conditions in the current economy which make that the case.

I can't sit here and tell you that that would always be the case, or that it would be the case or would be true in the case of every type of equipment. But, in this particular case, we are very comfortable with the conclusions of this analysis, and the Treasury Department has endorsed the approach to the tax cost that we have taken in this analysis.

Mr. PEASE. Is there a summary of that analysis which is a reasonable length?

Mr. MITCHELL. Yes, sir.

Mr. PEASE. Would you furnish that to the subcommittee, also?

Mr. MITCHELL. Yes, sir. I would also like to supply for the record, Mr. Pease, a copy of the letter we received from Treasury just today endorsing the methodology that we have used in this analysis.

[The information follows:]

DEPARTMENT OF THE TREASURY,
Washington, D.C., June 13, 1983.

WILLARD H. MITCHELL,
Principal Deputy Assistant Secretary, Financial Management, U.S. Air Force, Pentagon, Washington, D.C.

DEAR MR. MITCHELL: Colonel A.D.H. Wilbur has furnished us copies of your briefing materials, "Government Cost of Leasing: Tax Implications," covering an accounting for the revenue-side budget effects that would be associated with Air Force leasing of certain aircraft. The procedures described in that document are generally in accord with guidelines being developed jointly by the Treasury Department and OMB for evaluating the budget impact of tax deferrals that will be experienced by private lessors of depreciable property.

The forthcoming guidelines for evaluating Federal leasing of particular classes of property doubtlessly will refine both the discount rate and the reference depreciation rate (and, hence, the implicit residual value of the property on termination of the lease) as compared with the assumptions your staff has used in their quantitative analysis. However, none of these refinements would materially affect the conclusions that may be drawn from the sample calculations in the briefing materials, particularly in view of the fact that the investment tax credit is not involved in the contemplated lease. We would agree with the briefing estimates that, in present value terms, an amount equal to 8.5–10 percent of the government's cost of outright purchase should be added to the present value of contractors' 10-year lease rentals of the aircraft in question to arrive at a figure reasonably representing the total

budget cost (outlays plus tax deposit displacements) of leasing that property for comparison with the cost of full government ownership via purchase.

Sincerely,

J. GREGORY BALLENTINE,
Deputy Assistant Secretary.

Mr. PEASE. You anticipate my every need, and next question. Thank you very much.

Does this analysis include what would happen if you purchased the planes, exercised the option to purchase the planes at the end of the lease period?

Mr. MITCHELL. Yes, sir.

Mr. PEASE. It is still cost effective under those circumstances?

Mr. MITCHELL. Yes, sir.

Mr. PEASE. I would certainly like to see that.

[The information follows:]

OPERATIONAL SUPPORT AIRCRAFT REPLACEMENT COST ANALYSIS

CT-39 REPLACEMENT

PREPARED BY HQ USAF/ACMC

28 April 1983

(Revised on 7 September 83)

OPERATIONAL SUPPORT AIRCRAFT REPLACEMENT ANALYSIS

EXECUTIVE SUMMARY

BACKGROUND

Cessna's unsolicited proposal in July 82 offered the Air Force 104 new aircraft in exchange for a five year plus three year option for contractor logistics support (CLS) to maintain that fleet. Air Force did not have the authority to enter into such a contract and requested Congressional approval for a multi-year lease. GAO in reviewing the request accepted the savings over the CT-39 operation, but requested a lease-buy analysis. This analysis was provided, and Congressional approval for the lease was given in the Continuing Resolution Appropriation (CRA).

There was Congressional concern, though, that the savings of the lease might result in the shifting of costs from the DOD budget to the US Treasury, through the use of special tax incentives. Therefore Congress requested a second economic analysis, done on the basis of total cost to the Government. This study provides that analysis.

OPTION SUMMARY

Four scenarios were examined to show the impact on all options available to the Government:

1. Lease for eight years, then buy the leased aircraft.

2. Lease for 20 years.

3. Lease for eight years, then buy all new aircraft.

4. Buy all new aircraft now.

In addition, a sensitivity analysis was done on each scenario to determine if its results held true over a wide range of assumptions:

1. Purchase price was examined over a range of $2 to $3 million dollars.

2. Recovery of capital costs was examined over a range of $175 to $901/flying hour, corresponding to an annual recovery rate of 4.9% to 15%.

3. The discount rate was examined over a range of 6% to 14%.

ECONOMIC ANALYSIS RESULTS

The base case for each scenario was a purchase price of $2.5 million, a capital recovery of $175/flying hour.

The lease rate assumed a five year plus three year option period. The lease for 20 years option extended the five year option rates throughout the 20 years, rather than costing it as a 20 year lease.

The analysis used a discount rate of 10%, before taxes and after inflation, as prescribed by OMB Circular A-94. It included the cost of providing tax benefits (in this case, accerlerated depreciation) as part of the total cost of the leasing options. The treatment of tax impacts was in accordance with our understanding of current Treasury policy.

Applying the OMB discount rate and the Treasury-approved method for evaluating tax impacts to the CT-39 replacement options yeilds the following results: on both a constant year, and a discounted constant year basis the 20 year lease was most economical, closely followed by the lease and then buy lease aircraft option. The lease and then buy aircraft is the most expensive of the three lease options. However, this option would have a higher residual value at the end of the 20 year life as these aircraft would be eight years younger than an other option. If this higher residual value were to be taken into account, the cost of all three lease options would be very similiar. All replacement options were much less that continuing to operate the CT-39 on both a cost to the Air Force and cost to the Government.

Likewise, the full range of sensitivity analysis did not develop any scenario in which cost to either the Air Force, discounted or undiscounted was more than the cost of continuing to operate the CT-39. CHARTS 1 and 2 portray the results graphically.

Results of the contractor's responses to the Request for Proposal will provide firm data on which to make a final decision.

AIR FORCE POSITION

Based on the real savings we expect to gain from this program, the management flexibility inherent in the lease situation and the ability to materially upgrade the operation of the Operational Support Airlift, the Air Force strongly supports the lease option.

CHART 1
CT-30
SUMMARY OF RESULTS

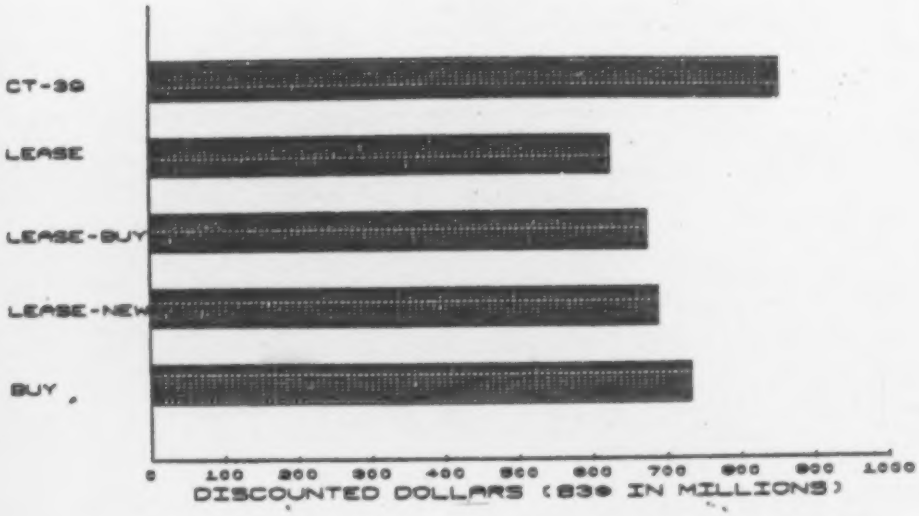
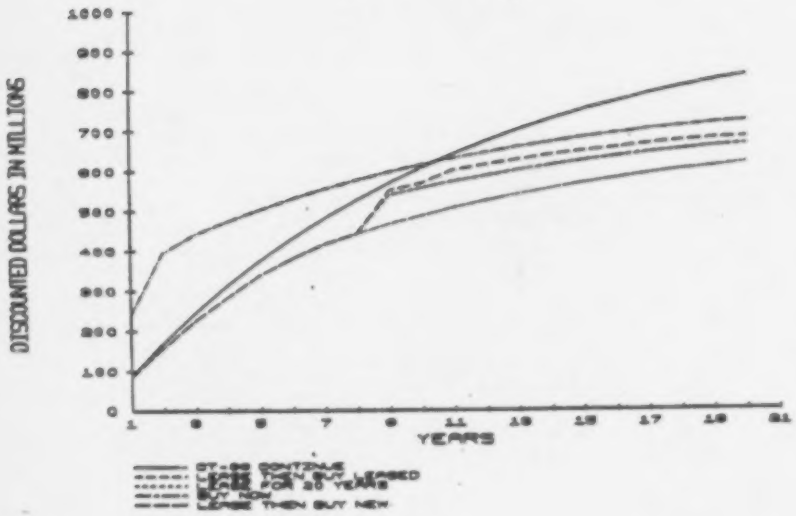


CHART 2
CT-30
SUMMARY OF RESULTS



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OPERATIONAL SUPPORT AIRCRAFT REPLACEMENT ANALYSIS

INTRODUCTION.

This study represents the Cost Analysis Division's understanding of the Treasury policy on leasing tax implications and is not official Air Force policy. It is in the process of coordination within the Air Force and OSD.

Its purpose is to examine the cost implications of the proposed Operational Support Aircraft (CT-39 replacement) lease. A wide range of alternative costs to the Air Force have already been provided to the Congress. This study, unlike previous studies, examines the cost of the Air Force compared to the cost of the Government in response to Congressional inquiries. It should be noted that the Air Force does not consider the CT-39 replacement decision to be lease/buy but rather lease/continue with the CT-39.

The difference between the cost of the Air Force and the cost of the Government is the treatment of income tax savings for the contractor (builder of the aircraft) and the Trust (lessor to the Air Force). It is assumed that there is only one source of tax break available, the accelerated depreciation (ACRS). The investment tax credit is not applicable because public law prohibits the use of the investment tax credit on leases to the Government.

In this study we have employed a discount rate of 10 percent, before taxes and after inflation, as prescribed by OMB Circular A-94. We have evaluated the tax impact of leasing as the difference between ACRS and straight line depreciation, and included that tax impact, and no others, as a cost to the government of leasing. We understand this to be the method for evaluating the tax consequences of leasing which reflects current Treasury policy.

The Air Force costs assume a lease price of $540/Flying Hour, which includes contractor logistics support and capital recovery. The purchase option assumes a price of $2.5M per aircraft plus contractor logistics support.

The tax on the profit on the sale of the aircraft to either the Government or the Trust, and on the interest paid by the aircraft manufacturer for loans used in the manufacture of the aircraft, will have exactly the same impact on Treasury cash flows. In addition, any outflows or inflows to the Treasury due to "reflows" of income or loans by third parties are identical. Therefore, since they would be exactly the same under any option , none of these costs are included in this analysis.

In addition, any profits on the contractor logistics support will be taxed the same whether the aircraft is purchased or leased and is, therefore, also treated as a wash in the analysis. The total contractor logistics support cost, however, is included in the Air Force costs for both the various lease and the buy options. The tax on any profit is the only item not included.

This study examines the economic consequences of the replacement of the Operational Support Aircraft under four options: (1) lease for eight years and then buy the aircraft, (2) lease the aircraft, (3) buy the aircraft, and (4) lease eight years then buy new aircraft. Because of the high cost of support required to operate and maintain the current CT-39 force, any of the replacement options considered is more economical than maintaining the existing fleet. The following sections of this analysis will discuss each of these alternatives.

Results are presented in FY 83 base year dollars and cumulative discounted FY 83 dollars for each option considered.

The Treasury inflows due to taxes consist of the following:

LEASE PAYMENT = (Lease Payment - Contractor Logistics Cost) * Tax Rate

The Treasury outflows due to taxes consist of the following:

ACRS EACH YEAR:

YEAR 1 = (.15 * Purchase Price * Quantity) * Tax Rate

YEAR 2 = (.22 * Purchase Price * Quantity) * Tax Rate

YEAR 3 = (.21 * Purchase Price * Quantity) * Tax Rate

YEAR 4 = (.21 * Purchase Price * Quantity) * Tax Rate

YEAR 5 = (.21 * Purchase Price * Quantity) * Tax Rate

STRAIGHT LINE DEPRECIATION:

FOR 20 YEARS, with a 20% residual value

Specific assumptions used in this study can be found in Appendix A. A sensitivity analysis of the impact of discount rate, lease cost and aircraft purchase price can be found in Appendix B.

LEASE THEN BUY THE LEASED AIRCRAFT VERSUS CT-39 OPERATION

The preferred alternative of the Air Force is to lease a replacement aircraft for five years with an option for an additional three years, then re-evaluate the decision as to buy or lease at that time. The market could be conducive to continuing to lease the same aircraft or a different aircraft; or it could be conducive to buying the currently leased aircraft or to buying a new aircraft. This section of the analysis assumes that the Air Force will buy the currently leased aircraft after eight years for Book Value, using the straight line depreciation method with a 20% residual value after 20 years. This results in a price which is probably higher than fair market value, which provides a conservative estimate. In addition, if the CT-39 were to be operated for another 20 years significant flight safety modifications, including wing re-skin, and new engines, would be required. These costs, which could increase the cost of CT-39 operations by over $100 million, have not been included, in order to provide a very conservative estimate.

METHODOLOGY

This option assumes the new leased aircraft will be delivered over a three year period and, therefore, requires retention of CT-39 aircraft during that period. The phasing out of the CT-39 aircraft is included in the "lease" cost to the Air Force column as can be seen during the first three years. The aircraft purchased in the 2nd and 3rd years are phased out in years 21 and 22 to provide the full fleet 20 years operations. The CT-39 is also extended to provide an equal capability. Purchase price at the end of the eight year period for the new aircraft is assumed to be "book value" to the Trust using straight line depreciation with a 20% residual value after 20 years. All aircraft are available to purchase and deliver in the ninth year which causes the increase in cost in that year. Air Force costs include all operating and support for both aircraft except crews, crew training and associated crew support costs. The Government costs include the Air Force costs, adjusted for the inflow/outflow of Treasury funds associated with the lease operation. The 10% discount rate was used for the analysis as it is prescribed by the Office of Management and Budget. All costs are computed in constant 1983 dollars.

CONCLUSIONS

TABLE 1 portrays the net annual costs to the Air Force and to the Government for the "lease then buy" vs "continue operating the CT-39" options based on OMB's 10 percent discount rate and the Treasury-approved method for evaluating tax impacts. Note that the lease tax impact columns represent the net inflow (+) or net outflow (-) to the Treasury for the tax advantage of ACRS less the tax generated by standard straight line depreciation. As can be seen in TABLE 1, the major advantage to the trust for entering into this type of arrangement is the accelerated depreciation deduction under the column labeled "ACRS."

That is, the five-year write-off allows for a major tax advantage, even without the investment tax credit.

The cumulative discounted cost shown in TABLE 2 illustrate that on a present value basis, when only Air Force costs are considered, the continued operation of the CT-39 is considerably more expensive than the "lease and then buy" option over the 20 year period. Considering the Treasury inflow/outflow with the Air Force costs, the "lease then buy" option increases somewhat because of the tax flows but is still considerably less than continued operation of the CT-39 force. A sensitivity analysis was run varying the input assumptions; results can be found in Appendix B.

This analysis was undertaken to compare the costs of "leasing then buying" an Operational Support Aircraft to replace the CT-39 with "continued operation" of the CT-39. The Air Force has not entered into this kind of procurement transaction before, but the current economic conditions of the aircraft industry and the recently passed tax laws to encourage investment have, at least temporarily, created an environment that appears to make this a viable alternative for both the Air Force and the Government to consider.

For the period of the initial lease, (five years with three year option) from either the Air Force or Total Government cost point of view, the lease then buy is more advantageous over the continued operation of the CT-39 option. In all cases considered, the life cycle costs to the Air Force and Government are favorable. Over the 20 year expected economic life of such an aircraft, in discounted or undiscounted dollars, the cost of lease then buy is less than the cost of continued operation of the CT-39.

TABLE 1

ASE	540.00
RCHASE	2.50
COVERY	175.00
X RATE	.46
Y HRS	700.00
ANTITY	120.00
SC RATE	.10

Operational Support Airlift
(dollars in millions)

Lease for 8 Years Then Buy Leased Aircraft

Year	Air Force Cost Lease/ Buy	Air Force Cost CT-39 Operate	Tax Impact ACRS	Tax Impact Straight Line	Tax Impact Net Impact	Govt Cost Lease/ Buy	Govt Cost CT-39 Operate
1	87.44	98.49	-6.21	-.83	-5.38	92.83	98.49
2	76.39	98.49	-15.32	-2.48	-12.83	89.23	98.49
3	67.80	98.49	-26.08	-4.42	-21.67	89.46	98.49
4	61.66	98.49	-29.53	-5.52	-24.01	85.67	98.49
5	61.66	98.49	-28.98	-5.52	-23.46	85.12	98.49
6	61.66	98.49	-20.29	-5.52	-14.77	76.43	98.49
7	61.66	98.49	-11.59	-5.52	-6.07	67.73	98.49
8	61.66	98.49	.00	-5.52	5.52	56.14	98.49
9	330.16	98.49	102.67	.00	102.67	227.49	98.49
10	46.96	98.49	.00	.00	.00	46.96	98.49
11	46.96	98.49	.00	.00	.00	46.96	98.49
12	46.96	98.49	.00	.00	.00	46.96	98.49
13	46.96	98.49	.00	.00	.00	46.96	98.49
14	46.96	98.49	.00	.00	.00	46.96	98.49
15	46.96	98.49	.00	.00	.00	46.96	98.49
16	46.96	98.49	.00	.00	.00	46.96	98.49
17	46.96	98.49	.00	.00	.00	46.96	98.49
18	46.96	98.49	.00	.00	.00	46.96	98.49
19	46.96	98.49	.00	.00	.00	46.96	98.49
20	46.96	98.49	.00	.00	.00	46.96	98.49
21	32.87	68.95	.00	.00	.00	32.87	68.95
22	18.78	39.40	.00	.00	.00	18.78	39.40
Total	1438.30	2078.23	-35.33	-35.33	.00	1438.30	2078.23

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TABLE 2

OPERATIONAL SUPPORT AIRCRAFT (CT-39)
(Dollars in Millions)
Lease for 8 Years Then Buy Leased Aircraft
Discounted Costs

	Air Force Cost		Tax Impact			Govt Cost	
Year	Lease	CT-39 Operate	ACRS	Straight Line	Net Impact	Lease*	CT-39 Operate
1	79.49	89.54	-5.65	-.75	-4.89	84.39	89.54
2	142.63	170.94	-18.30	-2.81	-15.50	158.13	170.94
3	193.57	244.94	-37.90	-6.12	-31.78	225.34	244.94
4	235.68	312.21	-58.07	-9.89	-48.18	283.86	312.21
5	273.97	373.37	-76.07	-13.32	-62.74	336.71	373.37
6	308.77	428.97	-87.52	-16.44	-71.08	379.85	428.97
7	340.41	479.51	-93.47	-19.27	-74.20	414.61	479.51
8	369.18	525.46	-93.47	-21.84	-71.62	440.80	525.46
9	509.20	567.23	-49.92	-21.84	-28.08	537.27	567.23
10	527.30	605.20	-49.92	-21.84	-28.08	555.38	605.20
11	543.76	639.73	-49.92	-21.84	-28.08	571.84	639.73
12	558.72	671.11	-49.92	-21.84	-28.08	586.80	671.11
13	572.32	699.64	-49.92	-21.84	-28.08	600.40	699.64
14	584.69	725.58	-49.92	-21.84	-28.08	612.77	725.58
15	595.93	749.15	-49.92	-21.84	-28.08	624.01	749.15
16	606.15	770.59	-49.92	-21.84	-28.08	634.23	770.59
17	615.44	790.08	-49.92	-21.84	-28.08	643.52	790.08
18	623.89	807.79	-49.92	-21.84	-28.08	651.97	807.79
19	631.57	823.90	-49.92	-21.84	-28.08	659.65	823.90
20	638.55	838.54	-49.92	-21.84	-28.08	666.63	838.54
21	642.99	847.85	-49.92	-21.84	-28.08	671.07	847.85
22	645.30	852.69	-49.92	-21.84	-28.08	673.37	852.69

LEASE FOR 20 YEARS VERSUS CT-39 OPERATION

This chapter presents "lease" versus "CT-39 operation" assuming that the Air Force decides to continue leasing the aircraft after the basic plus option period of eight years. Costs for modifying the CT-39 to include wing re-skin, new engines, and other possible necessary modifications are not included. These costs, of course, would increase the CT-39 costs.

METHODOLOGY

This option assumes the new leased aircraft will be delivered over a three year period and therefore require retention of CT-39 aircraft during that period. The phasing out of the CT-39 aircraft are included in the "lease" cost to the Air Force column and can be seen during the first three years. Aircraft purchased in the 2nd and 3rd year are phased out in years 21 and 22. Operation of the CT-39 is also extended to provide equal capability. Sales price at the end of the 20 year period for the new aircraft is assumed to be "book value" to the Trust using straight line depreciation with a 20% residual value and will be sold with the income tax being on ordinary income at 46%. The Air Force costs include all operating and support for both aircraft except crews, crew training and associated crew support for the new aircraft. The Government costs include the Air Force costs adjusted for the inflow/outflow to the Treasury for the tax consequences associated with the lease operation. The 10% discount rate was used for the analysis as it is prescribed by the Office of Management and Budget. All costs are computed in constant 1983 dollars.

CONCLUSIONS

TABLE 3 portrays the net annual costs to the Air Force and to the Government for the "extended lease" and "operate the CT-39" options, based on OMB's 10 percent discount rate and The Treasury-approved method for evaluating tax impacts. Note that the lease tax advantage columns represent the net inflow (+) or net outflow (-) to the Treasury for the tax advantages of the ACRS. As can be seen in TABLE 3, the major advantage to the trust for entering into this type arrangement is the accelerated depreciation deduction under the column labeled "ACRS". That is, the five-year write-off allows for a major tax advantage in the first few years, even without the investment tax credit.

The cumulative discounted costs shown in TABLE 4 illustrate that on a present value basis, when Air Force costs are considered, the continued operation of the CT-39 is considerably higher than the lease option over the 20 year period. When considering the Treasury inflow/outflow with the Air Force costs, the cost of the lease option increases somewhat because of the tax flows but is still considerably less than continued operation of the CT-39 force. A sensitivity analysis was run varying the input assumptions and the results can be found in Appendix B. As with the lease then buy option, the lease option is considerably cheaper for the Government over the 20 year period than operating the CT-39.

In all cases considered, the life cycle costs to the Air Force and Government are favorable. Considering the 20 year expected economic life of such a new aircraft, in discounted dollars, the cost of lease is clearly less than the cost of continued operation of the CT-39. It should be noted that the ACRS tax advantage to the contractor only runs for the first few year period of the initial lease. Over the 20 year life of the program the tax impact on the Treasury is zero. On a discounted basis the ACRS has a net negative impact, but not enough to offset the lease savings.

TABLE 3

LEASE	540.00
PURCHASE	2.50
RECOVERY	175.00
TAX RATE	.46
FLY HRS	700.00
QUANTITY	120.00
DISC RATE	.10

Operational Support Airlift
(dollars in millions)

Lease for 20 Years

Year	Air Force Cost Lease	Air Force Cost CT-39 Operate	Tax Impact ACRS	Tax Impact Straight Line	Tax Impact Net Impact	Govt Cost Lease	Govt Cost CT-39 Operate
1	87.44	98.49	-6.21	-.83	-5.38	92.82	98.49
2	76.39	98.49	-15.32	-2.48	-12.83	89.23	98.49
3	67.80	98.49	-26.08	-4.42	-21.67	89.46	98.49
4	61.66	98.49	-29.53	-5.52	-24.01	85.67	98.49
5	61.66	98.49	-28.98	-5.52	-23.46	85.12	98.49
6	61.66	98.49	-20.29	-5.52	-14.77	76.43	98.49
7	61.66	98.49	-11.59	-5.52	-6.07	67.73	98.49
8	61.66	98.49	.00	-5.52	5.52	56.14	98.49
9	61.66	98.49	.00	-5.52	5.52	56.14	98.49
10	61.66	98.49	.00	-5.52	5.52	56.14	98.49
11	61.66	98.49	.00	-5.52	5.52	56.14	98.49
12	61.66	98.49	.00	-5.52	5.52	56.14	98.49
13	61.66	98.49	.00	-5.52	5.52	56.14	98.49
14	61.66	98.49	.00	-5.52	5.52	56.14	98.49
15	61.66	98.49	.00	-5.52	5.52	56.14	98.49
16	61.66	98.49	.00	-5.52	5.52	56.14	98.49
17	61.66	98.49	.00	-5.52	5.52	56.14	98.49
18	61.66	98.49	.00	-5.52	5.52	56.14	98.49
19	61.66	98.49	.00	-5.52	5.52	56.14	98.49
20	61.66	98.49	.00	-5.52	5.52	56.14	98.49
21	43.16	68.94	.00	-3.86	3.86	39.30	68.94
22	24.66	39.40	27.60	-4.97	32.57	-7.90	39.40
Total	1347.67	2078.17	-110.40	-110.40	.00	1347.67	2078.17

TABLE 4

OPERATIONAL SUPPORT AIRCRAFT (CT-39)
OPERATIONAL SUPPORT AIRCRAFT (CT-39)
(Dollars in Millions)
Lease for 20 Years
Discounted Costs

	Air Force Cost		Tax Impact			Govt Cost	
Year	Lease	CT-39 Operate	ACRS	Straight Line	Net Impact	Lease	CT-39 Operate
1	79.49	89.54	-5.65	-.75	-4.89	84.39	89.54
2	142.63	170.94	-18.30	-2.81	-15.50	158.13	170.94
3	193.56	244.93	-37.90	-6.12	-31.78	225.34	244.93
4	235.68	312.21	-58.07	-9.89	-48.18	283.86	312.21
5	273.96	373.36	-76.07	-13.32	-62.74	336.71	373.36
6	308.77	428.96	-87.52	-16.44	-71.08	379.85	428.96
7	340.41	479.50	-93.47	-19.27	-74.20	414.61	479.50
8	369:17	525.45	-93.47	-21.84	-71.62	440.80	525.45
9	395.32	567.22	-93.47	-24.19	-69.28	464.60	567.22
10	419.10	605.19	-93.47	-26.31	-67.15	486.25	605.19
11	440.71	639.71	-93.47	-28.25	-65.22	505.92	639.71
12	460.35	671.09	-93.47	-30.01	-63.46	523.81	671.09
13	478.22	699.62	-93.47	-31.61	-61.86	540.07	699.62
14	494.45	725.56	-93.47	-33.06	-60.41	554.86	725.56
15	509.21	749.14	-93.47	-34.38	-59.08	568.30	749.14
16	522.63	770.57	-93.47	-35.58	-57.88	580.51	770.57
17	534.83	790.06	-93.47	-36.67	-56.79	591.62	790.06
18	545.92	807.77	-93.47	-37.67	-55.80	601.72	807.77
19	556.00	823.88	-93.47	-38.57	-54.89	610.90	823.88
20	565.17	838.52	-93.47	-39.39	-54.07	619.24	838.52
21	571.00	847.83	-93.47	-39.91	-53.55	624.55	847.83
22	574.03	852.67	-90.07	-40.52	-49.55	623.58	852.67

LEASE VERSUS BUY NOW

This option is included in response to the GAO letter suggesting the Air Force compare a buy option to the proposed lease in its study to replace the current CT-39 force. As with all other options the cost of CT-39 modifications is not included.

METHODOLOGY

This option assumes the new leased aircraft will be delivered over a three year period and therefore require retention of CT-39 aircraft during that period. The phasing out of the CT-39 aircraft is included in the "lease" cost to the Air Force column and can be seen during the first three years. Aircraft purchased in the 2nd and 3rd years are phased out in years 21 and 22 to provide a full 20 years operations for the fleet. The CT-39 is extended to provide equal capability. Salvage value at the end of the 20 year period for the new aircraft is assumed to be "book value" to the Trust using straight line depreciation with a 20% residual value. The residual value is taxed as ordinary income and added to the ACRS column. The Air Force costs include all operating and support for both aircraft except crews, crew training and associated crew support costs. The Government costs include the Air Force costs adjusted for the inflow/outflow to the Treasury for the tax consequences associated with the lease operation. The 10% discount rate was used for the analysis as it is prescribed by the Office of Management and Budget. All costs are computed in constant 1983 dollars.

CONCLUSIONS

TABLE 5 portrays the net annual costs to the Air Force and to the Government for the lease and buy options, based on OMB's 10 percent discount rate and The Treasury-approved method for evaluating tax impacts. Note that the lease tax impact columns represent the net inflow (+) or net outflow (-) to the Treasury for the tax advantages of the ACRS less the tax generated by standard straight line depreciation. As can be seen in TABLE 5, the major advantage to the trust for entering into this type of arrangement is the accelerated depreciation deduction under the column labeled "ACRS". That is, the five-year write-off allows for a major tax advantage, even without the investment tax credit.

The cumulative discounted costs shown in TABLE 6 illustrate that on a present value basis, when Air Force costs are considered, the lease is considerably less than the buy option over the 20 year period. When considering the Treasury inflow/outflow plus the Air Force costs, the cost of the lease costs increase somewhat because of the tax flows but is still significantly less than the buy option.

A sensitivity analysis was run varying the input assumptions and the results can be found in Appendix B. Graphically, the cumulative discounted costs for the Government are shown in Figure 2 in the Executive Summary

For the period of the initial lease, (five years with three year option) from either the Air Force or Total Government costs point of view, the lease is more advantageous over the buy option. In all cases considered, the life cycle costs to the Air Force and Government are favorable. Even considering the 20 year expected economic life of such an aircraft, in discounted dollars, the cost of lease is slightly less than the cost of the buy option.

Considering the large outflow from the Treasury in the early years to cover the cost of the buy option, it appears that it would be more favorable for both the Government and the Air Force to lease the aircraft and determine in five to eight years whether the conditions then favor buying the leased aircraft, continuing to lease the aircraft, or buying a new aircraft.

TABLE 5

LEASE	540.00
PURCHASE	2.50
RECOVERY	175.00
TAX RATE	.46
FLY HRS	700.00
QUANTITY	120.00
DISC RATE	.10

Operational Support Airlift
(dollars in millions)

Lease Versus Buy New Aircraft Now

	Air Force Cost		Tax Impact			Govt Cost	
Year	Lease	Buy	ACRS	Straight Line	Net Impact	Lease	Buy
1	87.44	263.03	-6.21	-.83	-5.38	92.82	263.03
2	76.39	187.57	-15.32	-2.48	-12.83	89.23	187.57
3	67.80	63.37	-26.08	-4.42	-21.67	89.46	63.37
4	61.66	46.96	-29.53	-5.52	-24.01	85.67	46.96
5	61.66	46.96	-28.98	-5.52	-23.46	85.12	46.96
6	61.66	46.96	-20.29	-5.52	-14.77	76.43	46.96
7	61.66	46.96	-11.59	-5.52	-6.07	67.73	46.96
8	61.66	46.96	.00	-5.52	5.52	56.14	46.96
9	61.66	46.96	.00	-5.52	5.52	56.14	46.96
10	61.66	46.96	.00	-5.52	5.52	56.14	46.96
11	61.66	46.96	.00	-5.52	5.52	56.14	46.96
12	61.66	46.96	.00	-5.52	5.52	56.14	46.96
13	61.66	46.96	.00	-5.52	5.52	56.14	46.96
14	61.66	46.96	.00	-5.52	5.52	56.14	46.96
15	61.66	46.96	.00	-5.52	5.52	56.14	46.96
16	61.66	46.96	.00	-5.52	5.52	56.14	46.96
17	61.66	46.96	.00	-5.52	5.52	56.14	46.96
18	61.66	46.96	.00	-5.52	5.52	56.14	46.96
19	61.66	46.96	.00	-5.52	5.52	56.14	46.96
20	61.66	46.96	.00	-5.52	5.52	56.14	46.96
21	43.16	32.87	.00	-3.86	3.86	39.30	32.87
22	24.66	18.78	27.60	-4.97	32.57	-7.90	18.78
Total	1347.67	1363.94	-110.40	-110.40	.00	1347.67	1363.94

TABLE 6

OPERATIONAL SUPPORT AIRCRAFT (CT-39)
(Dollars in Millions)
Lease Versus Buy New Aircraft
Discounted Costs

	Air Force Cost		Tax Impact			Govt Cost	
Year	Lease	Buy	ACRS	Straight Line	Net Impact	Lease	Buy
1	79.49	239.12	-5.65	-.75	-4.89	84.39	239.12
2	142.63	394.14	-18.30	-2.81	-15.50	158.13	394.14
3	193.56	441.75	-37.90	-6.12	-31.78	225.34	441.75
4	235.68	473.83	-58.07	-9.89	-48.18	283.86	473.83
5	273.96	502.98	-76.07	-13.32	-62.74	336.71	502.98
6	308.77	529.49	-87.52	-16.44	-71.08	379.85	529.49
7	340.41	553.59	-93.47	-19.27	-74.20	414.61	553.59
8	369.17	575.50	-93.47	-21.84	-71.62	440.80	575.50
9	395.32	595.41	-93.47	-24.19	-69.28	464.60	595.41
10	419.10	613.52	-93.47	-26.31	-67.15	486.25	613.52
11	440.71	629.98	-93.47	-28.25	-65.22	505.92	629.98
12	460.35	644.94	-93.47	-30.01	-63.46	523.81	644.94
13	478.22	658.54	-93.47	-31.61	-61.86	540.07	658.54
14	494.45	670.91	-93.47	-33.06	-60.41	554.86	670.91
15	509.21	682.15	-93.47	-34.38	-59.08	568.30	682.15
16	522.63	692.37	-93.47	-35.58	-57.88	580.51	692.37
17	534.83	701.66	-93.47	-36.67	-56.79	591.62	701.66
18	545.92	710.10	-93.47	-37.67	-55.80	601.72	710.10
19	556.00	717.78	-93.47	-38.57	-54.89	610.90	717.78
20	565.17	724.76	-93.47	-39.39	-54.07	619.24	724.76
21	571.00	729.21	-93.47	-39.91	-53.55	624.55	729.21
22	574.03	731.51	-90.07	-40.52	-49.55	623.58	731.51

LEASE THEN BUY NEW AIRCRAFT VERSUS CT-39 OPERATION

The preferred alternative of the Air Force is to lease a replacement aircraft with a lease of five years and an option for an additional three years then re-evaluate the decision as to buy or lease at that time. The market could be conducive to leasing the same aircraft or a different aircraft; or it could be conducive to buying the currently leased aircraft or to buying a new aircraft. For illustrative purposes this analysis assumes that the Air Force will buy a new aircraft after eight years. Costs for modifying the CT-39 to include wing re-skin, new engines, and other possible necessary modifications are not included. These costs, of course, would increase the CT-39 costs which provides a very conservative estimate.

METHODOLOGY

This option assumes the new leased aircraft will be delivered over a three year period and, therefore, require retention of CT-39 aircraft during that period. The phasing out of the CT-39 aircraft are included in the "lease" cost to the Air Force column and can be seen during the first three years. Purchase price at the end of the eight year period for the new aircraft is assumed to be the same as the original purchase option in constant year dollars. All aircraft are available to purchase and deliver in one year the cost of which shows up in the ninth year. The Air Force costs include all operating and support for both aircraft except crews, air crew training and associated support costs, and the lease/buy costs for the new aircraft. The Government costs include the Air Force costs adjusted for the inflow/outflow to the Treasury for the tax consequences associated with the lease operation. The 10% discount rate was used for the analysis as it is prescribed by the Office of Management and Budget. All costs are computed in constant 1983 dollars.

CONCLUSIONS

Table 8 portrays the net annual costs to the Air Force and to the Government for the lease-then-buy and maintain CT-39 options, based on OMB's 10 percent discount rate and the Treasury-approved method for evaluating tax impacts. On a present value basis, when only Air Force costs are considered, the continued operation of the CT-39 is considerably more expensive that the "lease and then buy" option over the 20 year period. When considering the Treasury inflow/outflow with the Air Force costs, the cost of the "lease then buy" option increases somewhat because of the tax flows but is still considerably less than continued operation of the CT-39 force. A sensitivity analysis was run varying the input assumptions; results can be found in Appendix B.

For the period of the initial lease, (five years with three year option) from either the Air Force or Total Government cost point of view, the lease then buy is more advantageous over the continued operation of the CT-39 option. In all cases considered, the life cycle costs to the Air Force and Government are favorable. Even considering the 20 year expected economic life of such an aircraft, the cost of lease then buy is considerably less than the cost of continued operation of the CT-39.

TABLE 2

LEASE	540.00
PURCHASE	2.50
RECOVERY	175.00
TAX RATE	.46
FLY HRS	700.00
QUANTITY	120.00
DISC RATE	.10

Operational Support Airlift
(dollars in millions)

Lease for 8 Years Then Buy New Aircraft

	Air Force Cost		Tax Impact			Govt Cost	
Year	Lease/ Buy	CT-39 Operate	ACRS	Straight Line	Net Impact	Lease/ Buy	CT-39 Operate
1	87.44	98.49	-6.21	-.83	-5.38	92.82	98.49
2	76.39	98.49	-15.32	-2.48	-12.83	89.23	98.49
3	67.80	98.49	-26.08	-4.42	-21.67	89.46	98.49
4	61.66	98.49	-29.53	-5.52	-24.01	85.67	98.49
5	61.66	98.49	-28.98	-5.52	-23.46	85.12	98.49
6	61.66	98.49	-20.29	-5.52	-14.77	76.43	98.49
7	61.66	98.49	-11.59	-5.52	-6.07	67.73	98.49
8	61.66	98.49	.00	-5.52	5.52	56.14	98.49
9	361.66	98.49	102.67	.00	102.67	258.99	98.49
10	46.96	98.49	.00	.00	.00	46.96	98.49
11	46.96	98.49	.00	.00	.00	46.96	98.49
12	46.96	98.49	.00	.00	.00	46.96	98.49
13	46.96	98.49	.00	.00	.00	46.96	98.49
14	46.96	98.49	.00	.00	.00	46.96	98.49
15	46.96	98.49	.00	.00	.00	46.96	98.49
16	46.96	98.49	.00	.00	.00	46.96	98.49
17	46.96	98.49	.00	.00	.00	46.96	98.49
18	46.96	98.49	.00	.00	.00	46.96	98.49
19	46.96	98.49	.00	.00	.00	46.96	98.49
20	46.96	98.49	.00	.00	.00	46.96	98.49
21	32.87	68.94	.00	.00	.00	32.87	68.94
22	18.78	39.40	.00	.00	.00	18.78	39.40
Total	1469.80	2078.17	-35.33	-35.33	.00	1469.80	2078.17

TABLE 8

OPERATIONAL SUPPORT AIRCRAFT (CT-39)
(Dollars in Millions)
Lease for 8 Years Then Buy New Aircraft
Discounted Costs

Year	Air Force Cost Lease	Air Force Cost CT-39 Operate	Lease Tax Advantage ACRS	Lease Tax Advantage Interest	Lease Tax Advantage Lease Paymt	Govt Cost Lease	Govt Cost CT-39 Operate
1	79.49	89.54	-5.65	-.75	-4.89	84.39	89.54
2	142.63	170.94	-18.30	-2.81	-15.50	158.13	170.94
3	193.56	244.93	-37.90	-6.12	-31.78	225.34	244.93
4	235.68	312.21	-58.07	-9.89	-48.18	283.86	312.21
5	273.96	373.36	-76.07	-13.32	-62.74	336.71	373.36
6	308.77	428.96	-87.52	-16.44	-71.08	379.85	428.96
7	340.41	479.50	-93.47	-19.27	-74.20	414.61	479.50
8	369.17	525.45	-93.47	-21.84	-71.62	440.80	525.45
9	522.55	567.22	-49.92	-21.84	-28.08	550.63	567.22
10	540.66	605.19	-49.92	-21.84	-28.08	568.74	605.19
11	557.12	639.71	-49.92	-21.84	-28.08	585.20	639.71
12	572.08	671.09	-49.92	-21.84	-28.08	600.16	671.09
13	585.68	699.62	-49.92	-21.84	-28.08	613.76	699.62
14	598.05	725.56	-49.92	-21.84	-28.08	626.13	725.56
15	609.29	749.14	-49.92	-21.84	-28.08	637.37	749.14
16	619.51	770.57	-49.92	-21.84	-28.08	647.59	770.57
17	628.80	790.06	-49.92	-21.84	-28.08	656.88	790.06
18	637.25	807.77	-49.92	-21.84	-28.08	665.33	807.77
19	644.93	823.88	-49.92	-21.84	-28.08	673.00	823.88
20	651.91	838.52	-49.92	-21.84	-28.08	679.98	838.52
21	656.35	847.83	-49.92	-21.84	-28.08	684.43	847.83
22	658.65	852.67	-49.92	-21.84	-28.08	686.73	852.67

SUMMARY

Because of age and operational requirements, the Air Force needs to consider replacing the current Operational Support Aircraft. The CT-39 force is approaching over 20 years in age and has a wartime requirement. The peacetime utilization of the aircraft for training and support airlift is a by-product of possessing the aircraft. The wartime requirements for operational support aircraft include movements of time-sensitive personnel, intelligence, spare parts, and medical supplies.

The Air Force has not entered into leasing situations such as the one being considered for the CT-39 replacement. Normally, when the decision is to lease or buy a new capability, the Air Force would prefer to buy that capability. However, with the current economic conditions and the recent unsolicited proposal to replace the CT-39 force, the Air Force has requested and received Congressional approval for authority to enter into a multiyear leasing arrangement. The circumstances surrounding each lease opportunity will vary, and thus leasing should be addressed on a case-by-case basis. Leasing is definitely not intended to circumvent the normal acquisition process within the Air Force or Government, but rather to complement it.

The results of this analysis show that in this particular case, based on OMB's 10 percent discount rate and the Treasury-approved method for evaluating tax impacts, mainly because of the high CT-39 operating and support costs, some form of leasing is not only feasible, but economical. The lease versus buy analysis shows that the costs are less for lease than buy, therefore leasing is a logical alternative for the Air Force to pursue. The following table and graphs summarize the results of the study showing that lease is the most favorable option.

TABLE 9

SUMMARY OF RESULTS

(FY 83 $) in Millions Discounted at 10%)

OPTION	20 Year AF Cost	20 Year Govt Cost
Lease Then Buy Leased Aircraft	$645	$673
Lease for 20 Years	$574	$623
Buy	$732	$732
Lease Then Buy New Aircraft	$659	$687
Continue CT-39 operation	$852	$852

In conclusion, the Air Force should proceed with the Request For Proposal process and re-evaluate the economic conditions of the market place at that time.

APPENDIX A

Assumptions Used in the Study

Lease price to the Air Force = $540.00 per Flying Hour
- Assumes Capital Recovery, profit, and Contractor Logistics Support

Purchase Price of Aircraft = $2.5 million

Recovery of Capital included in lease payments = $175.00 per Flying Hour
- Difference between this factor and lease price is Contractor Logistics Support

Tax Rate of the members of the Trust and the Aircraft manufacturer during the period of the study = 46%

Flying Hours per year per aircraft = 700

Quantity of aircraft procured or leased = 120

Discount Rate (Present Value) = 10%

Fuel Price = $1.176 per gal

APPENDIX B

SENSITIVITY ANALYSIS

The following items were subjected to a sensitivity analysis: Purchase Price, Lease Price, and Discount Rate. TABLE 10, below, summarizes the effect on the Government costs for each option for the variables subjected to the sensitivity analysis. As can be seen, varying the data over a wide range does not significantly change the conclusion that leasing a replacement is a prudent option for the Air Force to consider.

TABLE 10

EFFECT ON GOVERNMENT COSTS

PURCHASE PRICE	LEASE PRICE	DISCOUNT RATE	LEASE THEN BUY	LEASE	LEASE/ BUY NEW	BUY
2.0	540	10%	$650	$607	$656	$679
2.5	540	10%	673	623	687	732
3.0	540	10%	698	638	718	784
2.5	901	10%	814	787	828	732
2.5	540	6%	878	794	895	896
2.5	540	8%	765	698	780	805
2.5	540	12%	600	558	611	672
2.5	540	14%	539	507	549	623

Notes:
a. Costs in millions of 83$
b. All costs discounted.
c. Costs are cumulative for 20 years.

Mr. PEASE. You say the lessors are able to give you a lower lease price because the resale cost of the plane has held up fairly well.

What terms are there for the Air Force to purchase the planes at the end of the lease period? Does that reflect the high resale potential? In other words, will you have to pay a fairly high price at the end of a 5-year period?

Mr. MITCHELL. We will write the contract with the winning vendor such that we will have an option to procure the aircraft, buy the aircraft, at fair market value at the end of the lease. We cannot determine in advance what that would be. Were we to do so, the lessors would run some risk of loss of their tax status. And the exact value of the aircraft will, needless to say, be a product of negotiations at that time.

We have considered that, and we have factored back in the anticipated cost of the aircraft in the analysis.

Mr. PEASE. Thank you very much.

Chairman GIBBONS. So the Congress is really not preventing the Defense Department from buying an aircraft; we are really preventing some taxpaying private concern from buying the aircraft and leasing it to you. Is that right?

Mr. MITCHELL. I am sorry, Mr. Chairman. I am not sure I understand the question.

Chairman GIBBONS. Well, you are not going to be the owner of this aircraft, apparently. So some private concern is going to lease it to the U.S. Government; is that right?

Mr. MITCHELL. That is correct.

Chairman GIBBONS. So we have put a Buy American provision in here to prevent a private concern from purchasing the aircraft and leasing it back to the Government?

Mr. MITCHELL. If the provision is enacted into law as it now stands, I would say that would be the effect.

It is in the House bill and the Senate bill. I doubt it is not going to become law.

General WEISS. Maybe I can clarify it a little bit, Mr. Chairman.

The requirement is for the manufacturer to lease the aircraft. There will be no third parties in this business arrangement.

Chairman GIBBONS. Oh, this is a private concern, too?

General WEISS. Yes, sir.

Mr. PEASE. Will the chairman yield?

Chairman GIBBONS. Go ahead.

Mr. PEASE. The manufacturer is going to be the lessor?

Mr. MITCHELL. Yes, sir.

Now, that doesn't mean that he won't enlist the assistance of financial organizations to help place what we expect will probably be limited partnerships and other forms of debt to support the capital formation necessary to complete the manufacture of the aircraft. He will want to avail himself of rates for that capital that are as attractive as possible, and the most attractive rates can be had by packaging the capital in a form that investors with substantial tax liability can take advantage of the accelerated depreciation.

Mr. PEASE. Well, the manufacturer, though, would not be able to take advantage of the investment tax credit and accelerated depreciation on a product that the manufacturer made, would he?

Mr. MITCHELL. We have specifically ruled out the investment tax credit in the RFP as something which we believe this lease will not be eligible for. To be eligible for the investment tax credit, we would have to be entering into a service contract with the offerer, and that would entail the offerer flying the aircraft as well as maintaining them.

The contract we are seeking with the offerer will cover only the furnishing of the equipment and the logistical and maintenance support of the equipment. The Air Force has a continuing requirement for reasons of pilot training to provide crews for these aircraft.

So there will be no eligibility for the investment tax credit. But the offerer would be able to take advantage of the accelerated cost recovery depreciation schedule, we believe, under the current tax law. At least, our tax advisers have given us that opinion.

Mr. PEASE. Thank you, Mr. Chairman.

Chairman GIBBONS. You mean we are going to have training planes around at our different training bases that we are leasing, plus the fact we have already excluded any foreign manufacturer from bidding on them, and the manufacturer of the plane is going to maintain the plane?

Mr. MITCHELL. Yes, sir. And that is a very cost-effective way for us to operate this particular kind of aircraft. The manufacturer can create a cadre of maintenance personnel that is considerably smaller than we would require if we were to maintain these aircraft organically with blue suit personnel.

For that reason, his costs to furnish that maintenance to us are considerably lower than our own costs were we to try to maintain them ourselves.

Chairman GIBBONS. What type of aircraft?

Mr. MITCHELL. This is a small business jet, sir.

Chairman GIBBONS. Small business jet.

Mr. MITCHELL. About an 8-passenger aircraft; about a 2,000-mile range.

Chairman GIBBONS. And it is used for training? You call it a CT?

Mr. MITCHELL. Yes, sir.

We have a requirement to maintain a large cadre of trained pilots in the Military Airlift Command for wartime contingency. These are pilots who will be part of the augmentation necessary to fly the very heavy schedules for C-5's, C-114's, and C-130's.

In peacetime, however, to keep them proficient, were we to be training them on those aircraft, would be extremely expensive. And so we have maintained for a long time a fleet of smaller and more fuel-efficient aircraft as a way of sustaining that level of training within the Airlift Command.

Now, in addition, we use the aircraft to ferry personnel as an incidental part of completing the training mission.

Chairman GIBBONS. These are jets and prop jets; is that right?

Mr. MITCHELL. The current inventory is all jet, but we have been directed by the committees to replace them with a mix of props and jets, yes, sir.

Chairman GIBBONS. Yes.

Now, I assume the pilots you will be training are mainly Guard and Reserve pilots; or are they active duty pilots?

Mr. MITCHELL. No, sir. They will be primarily active duty pilots. There will probably be some Guard and Reserve pilots, as well. The aircraft will be assigned primarily to active duty units. But we do rotate Guard and Reserve pilots through some of these units, and they would have the opportunity to fly the aircraft, as well.

Chairman GIBBONS. Are you able to tell us the name of the foreign country that is believed to be subsidizing their aircraft?

Mr. MITCHELL. I am not, sir. As I say, that was a general concern expressed in the committee's report language, and I frankly don't know to whom they are referring.

Chairman GIBBONS. Would it have made any difference to you if there had been a foreign bidder on this type of lease arrangement?

Mr. MITCHELL. No, sir. To have been competitive, I suspect, quite frankly, that the foreign offerer would have had to have arranged to place much of the lease financing within the United States, with U.S. investors, so as to avail themselves of the advantages of the American tax law at the moment. But we would have had no objection to a foreign offerer as a winning vendor in this procurement.

Chairman GIBBONS. All right. Well, I don't have any further questions.

Let me thank all three of you for coming and for being very responsive.

We will conclude this hearing today. We may open it up a little later on as more develops. But we appreciate very much your coming.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]

[The following was submitted for the record:]

STATEMENT OF DAVID J. STEINBERG, PRESIDENT, U.S. COUNCIL FOR AN OPEN WORLD ECONOMY, INC.

(The U.S. Council for an Open World Economy is a private, non-profit, public-interest organization engaged in research and public education on the merits and problems of developing an open international economic system in the overall national interest. The Council does not act on behalf of any private interest.)

The record will show that, over a considerable span of years, the only publicly voiced objection to the Buy American strictures affecting defense procurement has come from the U.S. Council for an Open World Economy (see, e.g., hearings of the House and Senate subcommittees on defense appropriations). The Council has not absolutely opposed Buy American requirements in defense procurement, rather the current pattern of such requirements. It is opposed to such strictures unless they are found to be indispensable as integral parts of coherent strategies of aid to needy and deserving sectors of our economy in the overall national interest, or deemed necessary for other worthy purposes in the total national interest. Thus, for example, there should be no special Buy American rules on specialty metals or textiles except as part of coherent redevelopment strategies for these industries. No such strategies for industries receiving special Buy American subsidies (as distinct from comprehensive Buy American policies) currently exist. Moreover, the Council has urged that the government assess the cost of Buy American requirements—as part of systematic review of such subsidies (no such review has ever been required) to determine if and to what extent such assistance may still be necessary. Among other benefits, such reform would help to combat inflation and reduce the government's fiscal deficit.

It is in the spirit of such a position that we here express our objection to the Buy American restriction passed by the House of Representatives on May 25, 1983 concerning replacement aircraft for the CT-39 (Title I, Chapter III, of H.R. 3069, Supplemental Appropriations for Fiscal Year 1983). The structure prohibits replacement for the CT-39 "from other than a United States firm and such replacement aircraft must be assembled in the United States and utilize an airframe manufactured in the United States."

This measure does not appear to be part of a coherent policy of balanced government aid to an industry for which the need for assistance at public expense has been clearly documented. It appears, rather, to be one more addition to the simplistic subsidies that, over the years, have accumulated in the array of Buy American requirements affecting defense procurement. This one seems to be a subsidy to U.S. suppliers of airframes for aircraft capable of replacing the CT-39. (There appears to be no concern about where all the other parts of the aircraft are made. Note the provision that the aircraft must only be *assembled* in the United States; only the airframe must be made in the United States.)

To be justifiable in the national interest, such a Buy American provision should have to be shown to be required as an indispensable part of a coherent program of clearly needed assistance to the U.S. industry for whose benefit this subsidy is intended. The structure (and the aid program of which it should be part) should be reexamined every year (the statute should so require). Its cost to the nation, in financial and other terms, should be assessed, made known to Congress and, consistent with security standards, made public.

Thus, at least in its present form, the measure in question should not be allowed to stand. The time has come to dismantle simplistic varieties of import control, not add to them.

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